Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-6386-99
JJSweeney

date:

to: Chief Examination Division, Manhattan District
Attn: CEP Manager [redacted], Branch 4

from: District Counsel, Manhattan

subject: **Taxpayer:** [redacted]
EIN: [redacted]
Taxable Years: [redacted] **through** [redacted] **(Form 1065 Returns)**
UIL: 864.01-02

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Issues

This memorandum responds to your request for written advice concerning two alternative grounds for considering whether [redacted] was engaged in the conduct of a U.S. trade or business for the years at issue, such that its foreign limited partners would, under the attribution rules under I.R.C. § 875, be deemed engaged in a U.S. trade or business by reference to the activities of [redacted]. For this determination, the first issue is whether [redacted] was trading in stocks and/or securities within the U.S., and, if so, whether such activities would qualify as the conduct of a U.S. trade or business under Treasury Regulation § 1.864-2(c). The second issue is whether [redacted] engaged in a U.S. trade or business for the years at issue based on the theory that [redacted]'s activities qualified as the active conduct of a banking, financing or similar business within the meaning of Treasury Regulation § 1.864-4(c)(5)(i).

[redacted] (b)(7)a

(b)(7)a [redacted][1].

Facts

[redacted] was formed in [redacted] as a Delaware limited partnership with its [redacted]. The general partner of [redacted] is [redacted], a New York partnership that is itself engaged in banking and investment banking activities and that maintains offices in, among other places, New York, New York.

The private placement memorandum dated [redacted] and other offering materials for [redacted] indicate that its principal purpose is to make equity investments in medium-sized (i.e., capitalizations between $[redacted] to $[redacted]) publicly owned U.S. corporations to achieve above average total returns, consisting of both current income and capital appreciation. These investments would result in [redacted] owning significant equity interest in such companies and would, in cases in which investments were not publicly traded, be valued by the general partner based on criteria it deemed appropriate. [redacted] had a defined term of [redacted] years, which could be extended based on [redacted] annual extensions if requested by the general partner and agreed to by at least [redacted]% of the limited partner interests.

[redacted] was not authorized to incur debt, but would raise capital of $[redacted] through the sale of limited partnership interests to domestic and foreign corporate and institutional investors. The type of investor deemed suitable as a limited partner of [redacted] was a company able to make a long-term investment, to bear the risk of losing its partnership investment, and to have no need for liquidity in the investment. When [redacted] was to make an investment, each limited partner would be required to contribute additional capital unless it elected-out of that investment. Consistent with its offering materials, limited partner interests were sold to both domestic and foreign corporations. [redacted], on the other hand was not required to contribute any capital for its interest in the income from the

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[1] Note that this memorandum covers only whether the foreign limited partners of [redacted] will be considered engaged in a U.S. trade or business solely by reference to the activities of [redacted]. It does not address whether any of the foreign partners that are already be engaged in a U.S. trade or business under I.R.C. § 864 based on their own activities in the U.S. might, under Treas. Reg. § 1.864-4, be required to report some or all of their distributive shares of [redacted]'s net income as effectively connected to their U.S. businesses.

investments, and it also received a fee for managing them based on a percentage of the corpus of the investments.

In connection with [redacted]'s above described investments, it was anticipated that [redacted] would earn fee income. In an [redacted] supplement ("the supplement") to the [redacted] private placement memorandum, [redacted] noted that it could receive commitment fees, break-up fees, placement fees, and closing fees from the companies in which it invests. The supplement said that any such fees would be allocated [redacted]% to the general partner and [redacted]% to the limited partners. The supplement further noted that [redacted] would not receive any fees for investment banking and advisory services rendered by the general partner to any company in connection with [redacted]'s investment in such company and that the general partner itself could receive such fees in connection with an investment only if so approved by the limited partners.

In [redacted] and [redacted], [redacted] solicited numerous companies in connection with its goal of purchasing privately placed securities. [redacted] completed [redacted] such investments during those 2 years, all of which were privately placed deals negotiated between [redacted]'s general partner and each investee company. These investments generally consisted of a note and/or preferred stock that was convertible into the common stock of the investee. In some cases, [redacted] was also issued warrants to purchase common stock of the investee. Each investment was supported by a written agreement setting forth the terms of the deal and the covenants and representations of [redacted] and the investee.

As part of at least several of these deals, [redacted] received what the parties labeled "facilitation fees." With respect to [redacted]'s convertible debt investments, [redacted] was effectively paid these fees through a reduction in the purchase price of the investment and presumably treated the fees as discount income (i.e., additional interest) for federal income tax purposes. With respect to the investments in convertible preferred stock, [redacted] was paid the fee in full at the closing of a deal. No information has been provided on why [redacted] received these fees, and the purchase agreements submitted to us do not elaborate on this point. It is unclear, therefore, what services, if any, [redacted] performed in connection with these fees. In this regard, it is also unclear what activities [redacted] employees conducted in connection with [redacted]'s capacity as [redacted]'s general partner and unclear as to the number of [redacted] employees dedicated to such activities.

By [redacted], the first tax year at issue, [redacted] still owned the above referenced investments and did not purchase any other privately placed securities.

With respect to the treatment of its foreign limited partners for U.S. tax purposes, [redacted] determined that it was not engaged in a U.S. trade or business under I.R.C. § 864. [redacted] therefore treated the distributable income of the foreign partners as fixed or determinable annual or periodic income under Treas. Reg. § 1.881-(b). Unless otherwise indicated by a foreign partner, [redacted] withheld at source under I.R.C. § 1442 on such income distributed to the foreign partners, after considering any domestic law or treaty [redacted] deemed applicable as a basis for reducing the rate of withholding otherwise required under I.R.C. § 881(a).

Law and Analysis

Issue 1: Trading vs. Investing

The first issue is whether [redacted] can be deemed engaged in a U.S. trade or business based on a determination that [redacted] was trading for its own account within the United States. In this connection, Treasury Regulation § 1.864-2(c)(2)(ii) covers when a foreign or domestic partnership is, with respect to activities in connection with stocks and/or securities, deemed engaged in a U.S. trade or business. This Regulation provides generally that a partnership is not engaged in a trade or business in the U.S. solely because it effects transactions in stock and securities in the U.S. for it own account. It further provides two exceptions to that rule. These exceptions state that transactions in stocks and securities by a partnership will constitute the conduct of a U.S. trade or business when either (1) the partnership is itself a dealer in stock or securities[2], or (2) the partnership's principal business is trading in stocks and securities for its own account, but only if the partnership's principal office is in the United States[3]. In this case, as [redacted]'s [redacted], it is indisputable that [redacted]'s principal office was in the U.S.

Consequently, the issue of whether [redacted] was trading in stocks and securities is relevant for determining whether the

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[2] As, based on the offering materials, [redacted] does not appear to fit within the definition of a dealer under Treas. Reg. § 1.864-2(c)(2)(iv), and as this issue was not raised for consideration, it is not discussed further herein.

[3] Note that this second exception does not apply when in certain circumstances a partnership is owned by 5 or fewer partners who are individuals. As this situation is inapplicable to this case, further discussion of it is omitted.

second exception under Treas. Reg. § 1.864-2(c)(2)(ii) applies here. This issue is important because cases have repeatedly held that the holding of securities as investments does not amount to engaging in a business, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941), and that this finding applies even when a taxpayer expends considerable effort in searching for investment opportunities and in managing its investments. Abegg v. Commissioner, 50 T.C. 145 (1968), aff'd. 429 F.2d 1209 (2nd Cir. 1970). As a result, if [redacted] were engaged solely in investing rather than trading, the common law rules that determine what constitutes a trade or business for federal income tax purposes would result in a finding that [redacted] was not engaged in a U.S. trade or business[4].

In distinguishing between trading and investing, the Courts have focused on the length of the holding period and the source of the profits. Yaeger v. Commissioner, 889 F.2d 29 (2nd Cir. 1989). In this connection, investing has been held to mean buying and holding securities to obtain dividend and interest income and long-term appreciation. Id., F.2d at 32, citing, Moller v. Commissioner, 721 F.2d 810, 813 (Fed., Cir. 1983), cert. denied 467 U.S. 1251 (1984). In Yaeger, for example, the Court held that the taxpayer was an investor because he held most of his stock for over one year, he realized both interest and dividends, and he profited when he held undervalued stock until the market improved. Id., F.2d at 33. In contrast, trading occurs when securities are bought and sold during short holding periods to realize profits from market fluctuations. Liang v. Commissioner, 23 T.C. 1037 (1955).

In this case, [redacted] would likely be considered an investor given the representations in the offering materials that [redacted]s objectives were to achieve income and capital appreciation by purchasing equity interests. Moreover, [redacted] appeared to implement that plan because its security holdings for the [redacted] taxable year consisted of the securities purchased in [redacted] and [redacted], and because its income for [redacted] consisted of interest and dividends. Accordingly, [redacted]'s business purpose, as both represented and demonstrated, was, at least up to the years at issue, to achieve income and long-term appreciation.

The case law does suggest, however, that a trade or business may exist when an investor receives compensation above the return

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[4] In determining whether a taxpayer is conducting a trade or business, the same standard applies for both resident and nonresident taxpayers. Letter Ruling 199909004, citing Liang v. Commissioner, 23 T.C. 1037, 1040 (1956).

of a normal investor because of services provided in promoting a corporation for a fee or commission. Whipple v. Commissioner, 373 U.S. 193 (1963). This situation is also covered in Treas. Reg. § 1.864-2(a), which provides the general rule that the performance of services within the U.S. during a taxable year qualifies as engaging in a U.S. trade or business. Here, [redacted] agreed to forego earning investment advisory fees, but it was paid facility fees upon purchasing most of its securities. [redacted]

(b)(5)(AC), (b)(5)(DP)

Issue 2: Engaging in a Banking or Financing Business

The second issue is whether [redacted] activities in purchasing convertible debts and convertible preferred stocks is sufficiently similar to a banking or financing business to conclude that it engaged in a U.S. banking, financing or similar business under Treasury Regulation § 1.864-4(c)(5)(i). This Regulation states that a foreign corporation is considered

> to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States:
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> (a) receiving deposits of funds from the public,
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> (b) making personal, mortgage, industrial, or other loans to the public,
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> (c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,
>
> (d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,
>
> (e) Providing trust services for the public, or

(f) financing foreign exchange transactions for the public.

Although this Regulation provides guidance on what constitutes a banking, financing, or similar business, a predicate for consideration under this Regulation is that "the taxpayer is engaged in business in the United States." Id. Therefore, even if it were assumed that [redacted] engaged in one of the banking activities described in this Regulation because some of the private placements contained features characteristic of banking loans[5], the threshold question is whether those functions rose to the level of a U.S. trade or business. In this determination, the key factor is whether [redacted]'s activities in entering into the private placements were regular and continuous. See, Lewenhaupt v. Commissioner, 20 T.C. (1953); United States v. Henderson, 375 F.2d 36, 41 (1967)(taxpayer made several loans but did not do so regularly and continuously). (b)(7)a, (b)(5)(DP) [redacted][6].

Another argument against concluding that [redacted] engaged in a U.S. banking or financing business arises from [redacted]'s focus on acquiring equities. In a case in which a partnership engaged in some lending transactions but had an overriding objective to

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[5] Some strong arguments can be made that privately placed debts are more similar to loans than publicly-traded securities. See, Mark S. Cary et al., Recent Developments in the Market for Privately Placed Debt, 80 Fed. Res. Bulletin No. 1, pg. 5. For example, both bank loans and private placements are information sensitive, such that the lenders in both the bank loan and private placement markets are financial intermediaries with expertise in evaluating and monitoring credit risks. Id.

[6]Note that in Inverworld v. Commissioner, T.C. Memo, 1996-301, the Court's evaluation of which activities enumerated in Treas. Reg. § 1.864-4(c)(5)(i) that a foreign taxpayer performed was the criteria for holding that the taxpayer engaged in a U.S. trade or business. In this analysis, however, the Court noted that at least some of the banking and finance functions performed by the taxpayer were so performed on a regular basis. Note further that the Court found that the taxpayer engaged in four of the activities enumerated in Treas. Reg. § 1.864-4(c)(5)(i) as banking or financing functions.

profit from its appreciating stocks and warrants, it was held that the partnership was not engaged in a trade or business for purposes of claiming a deduction for business bad debts. Betts v. Commissioner, 62 T.C. 536 (1974). In Betts, the Court found that although the taxpayer had entered into two loans, those transactions were made to satisfy the partnership's investment objectives, such that the partnership was not engaged in a trade or business. In this case, although [redacted] purchased some convertible debts, it also purchased preferred stock. But regardless of whether [redacted] initially acquired debts or preferred stock, the end result of a potential conversion was generally to acquire common stock. [redacted] (b)(7)a [redacted] (b)(5)(AWP) [redacted] (b)(5)(AC) [redacted].

Further note that determining whether a taxpayer is engaged in a U.S. trade or business is a yearly determination. See, Treas. Reg. § 1.881-(b). Accordingly, this memorandum does not express an opinion on whether [redacted] was engaged in a U.S. trade or business for the taxable years preceding those at issue.

If you have any questions concerning the advice provided in this memorandum, please contact John Sweeney at (212) 264-1595, ext. 263.

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